

MediaOne and TCI cable networks. AT&T's physical access to TCI's customers does no good to consumers in MediaOne's service areas who are currently captive to their existing telephone service providers.

38. Conversely, the merger will give MediaOne access to the existing network infrastructure that AT&T obtained through its acquisition of TCG. Through its acquisition of TCG, AT&T owns a limited number of wire centers and transport facilities used to provide service to large business customers in some of MediaOne's cable markets. AT&T uses these facilities to connect some of its customers directly to its long distance network and thereby bypass incumbent LECs' exchange access facilities and non-cost based access charges. AT&T can also use the facilities to interconnect to incumbent networks at end offices rather than tandem switches, thereby avoiding the incumbent LECs' charges for tandem switching and shared transport. In contrast, MediaOne has few transport assets. It normally must interconnect to incumbent networks through tandem switches for both local exchange and exchange access calls. By combining MediaOne's cable facilities with AT&T's existing (albeit limited) large business local telephone infrastructure, the merger should allow some cost reductions in the provision of local and long distance service to some MediaOne customers. *See McGee Decl.*¹

¹ Bell Atlantic's claim that the Commission should be concerned about the loss of potential mass market local telephone competition in MediaOne's service areas between MediaOne and AT&T is plainly misguided. AT&T's ownership of limited switching and transport facilities that it uses to provide competing service to large business customers does nothing to overcome the mass market local *loop* bottleneck that prevents AT&T – in the absence of the MediaOne facilities that can be used to bypass that bottleneck – from effectively competing with the incumbent LECs.

39. Another key asset that AT&T brings to the table is its brand name. It is common knowledge that the AT&T brand has a very high reputation among consumers of telecommunications service; by contrast, cable companies suffer from a popular perception as unresponsive customer-unfriendly monopolists. *See, e.g., AT&T-TCI* ¶ 47. As the Commission has recognized, brand and reputation are extremely important in attracting customers away from a dominant provider to a new and relatively untested means of providing service. *AT&T-TCI* ¶ 148. A reputation for average or less than average service and quality is extremely difficult to correct.

40. MediaOne's existing efforts to market cable telephony underscore the competitive handicap of a firm lacking a well-established telephony brand name like AT&T's. MediaOne has invested billions of dollars to upgrade its system to provide cable telephony, yet has attracted only a few tens of thousands of telephone customers. *See McGee Decl.* We understand that absent the AT&T merger, MediaOne projected that it would not achieve significant customer penetration levels for at least a decade. *See id.* MediaOne believes (and has apparently heard from customers themselves) that this slow rate of penetration stems, in large part, from the unwillingness of consumers to buy a service as basic and essential as local telephone service from a firm without an established reputation for reliable, high quality service. *See id.* By reputation, MediaOne is a good cable company. But the business models in the cable business are very different from those in the telephone business. Because consumers regard telephone service as a lifeline in medical and other emergencies, the quality of service and customer care are much more important for telephony than for

cable. As the Commission has recognized, *AT&T-TCI* ¶ 47-48, the AT&T brand has an extremely high reputation for reliability among consumers.

41. AT&T and MediaOne have also identified synergies in their relevant experience and expertise. AT&T has much more experience in competitive markets than does MediaOne. It has honed its marketing and competitive response skills against MCI, Sprint and hundreds of other aggressive rivals in the long distance business for nearly two decades. More recently, it has gained costly but invaluable experience negotiating the hurdles of obtaining interconnection and unbundled network elements from incumbent LECs. It has significant experience in mass market Internet business through its WorldNet offerings, and its recent purchase of IBM's IGN network earlier this year. We understand that AT&T also has extensive experience in the development of packet switching IP telephony, which is more efficient and flexible than the circuit switching architecture of MediaOne's existing cable telephone network. *See Holmes Decl.* These kinds of marketing, regulatory and engineering experience are enormously valuable strategic assets.

42. MediaOne has the edge in other areas of expertise. MediaOne has a head start in deploying cable telephony with a circuit switching architecture. Acquiring this know-how will enable AT&T to jump-start its deployment of cable telephony on the TCI system until IP-based cable telephony can be deployed. *See McGee Decl.* And MediaOne has developed technological and practical experience and expertise in installing and maintaining the necessary customer premises equipment. It is likely that AT&T can also benefit from these investments after consummation of the merger. *See id.*

43. The final merger efficiencies identified by AT&T and MediaOne involve scale and clustering. It is well established that the deployment of new telephony and internet services over cable requires an enormous fixed investment in research and development; development of engineering protocols and operating standards and practices; construction and furnishing of central offices, transport facilities and databases; hiring and training of installation and maintenance crews; and establishment and staffing of customer care centers. We understand that the costs of marketing new cable service to mass market residential consumers are also large, and, in part, fixed. *See, e.g., McGee Decl.; Holmes Decl.*

44. As the Commission has recognized, the ability to spread fixed costs among a large customer base gives the dominant incumbent providers an enormous cost advantage, and hence an enormous competitive edge. *See Local Competition Order* ¶11. These advantages are particularly stark on the telephony side – incumbent LECs today serve virtually all the customers available in contiguous territories of vast geographic scope – but AOL has similar advantage in the provision of online services. If new entrants are to compete with incumbent LECs and leading Internet and online service providers, they also must have the opportunity to serve a large customer base.

45. Incumbent LECs enjoy a further advantage from their ability to position key assets to serve clusters of contiguous customers or service territories. Clustering can increase localized management, allow more efficient architecture, reduce per-customer marketing, maintenance and operating costs, foster regional programming, such as news and sports, and enhance compatibility of customer premises equipment. *See, e.g., Holmes Decl.* In these circumstances, there is every reason

to credit AT&T's and MediaOne's prediction that this merger, by allowing them to aspire to become a facilities-based competitor with a scale and scope currently enjoyed only by dominant service providers, promises increased competition and choice across the whole range of services that will be provided to mass market consumers over alternative networks as technologies and services converge.

46. In this regard, it is important to recognize a fundamental difference between incumbent LECs and cable providers. We understand that completion of the MediaOne merger will give AT&T control of cable facilities that pass roughly the same number of households that would be passed by the facilities of Ameritech-SBC-PacBell or Bell Atlantic-NYNEX-GTE. For AT&T and MediaOne, however, these households translate to far fewer *customers*. *First*, cable and telephone services have dramatically different penetration rates: on average, 94 percent for telephone and 65 percent for cable. Thus, even when a cable company passes as many homes as a telephone company, it has almost 30 percent fewer customer relationships.² *Second*, as new entrants into the telephony market, cable companies start with *no* telephone customers. *Third*, as noted above, cable companies must expend enormous sums of money to research, develop, and implement broad-scale cable telephony networks, while incumbent LECs already have ubiquitous networks in place. Thus, to achieve the same economies of scale and compete on an equal footing with incumbent LECs, cable

² Compare *Seventh Report & Order and Thirteenth Order on Reconsideration, In the Matter of Federal-State Board*, CC Docket No. 96-45, ¶ 38 (May 28, 1999) (94.2 percent telephone subscribership rate as of November 1998); Fifth Annual Report, *In re status of Competition in Markets for the Delivery of Video Programming*, CS Docket No. 98-102, ¶ 17 (Dec. 23, 1998) (cable penetration of 68.8 percent at the end of June 1998).

companies must be permitted to achieve footprints as least as large, or larger, than the footprints of large incumbents.

47. In short, the complementary assets and expected synergies that AT&T and MediaOne have identified are of the types that economics and experience teach are most likely to produce benefits to the public, particularly where, as here, they promise to create a more effective competitor to existing monopoly providers.

48. The merger opponents attack a straw man. They claim that both AT&T and MediaOne would invest in telephony even without the merger. We have no reason to question that prediction, and are not aware that the Applicants have ever claimed otherwise. But the relevant question is not whether either or both firms would go it alone if the merger were disapproved, but whether combining the two firms' complementary assets would permit facilities-based competitive entry that is faster, broader, and more cost-effective than going it alone. The experiences to date of MediaOne, AT&T and competitive LECs – and the unprecedented competitive responses, discussed below, already spawned by the mere announcement of the AT&T/MediaOne strategy – suggest to us that AT&T and MediaOne are right in claiming that neither one would have been as successful alone in trying to bring choice and competition to captive local telephone customers in MediaOne's service areas. *See McGee Decl.*

49. Finally, a brief response is warranted to Bell Atlantic's claim that the increased competition resulting from the merger should be counted as a public interest benefit only if AT&T

promises to offer plain old telephone service ("POTS") over MediaOne's cable network, unbundled from services such as cable television or high-speed Internet access. The merger benefits consumers by offering them competition and more options for many services. The notion that no competitive benefit can occur unless the new entrant replicates *every* service provided by the incumbent is inconsistent with antitrust and regulatory economics. In any event, we understand that AT&T does offer unbundled POTS.

C. The Competitive Benefits Of The Merger Have Already Begun To Materialize.

50. As is often the case, the actual behavior of firms in the marketplace is much more informative than their statements in adversary proceedings. The best evidence that the merger, and not business as usual, creates the best prospect for widespread near-term competition is the incredible pace and breadth of the *anticipatory* competitive responses following the mere announcements of AT&T's plans to invest tens of billions in cable-based alternatives to dominant providers' services.

51. AT&T's announcements that it will begin to provide competing local telephony and Internet services over facilities purchased from TCI and MediaOne has triggered nothing less than a competitive avalanche. As AT&T and MediaOne detail in the public interest section of their reply comments, all of the major incumbent LECs (as well as AOL, the leading internet service provider) have abandoned their long-standing reluctance to market DSL and broadband services since AT&T announced the TCI and MediaOne mergers. And where AT&T-delivered cable telephony services have been rolled out, incumbent LECs have responded swiftly with their own price cuts. These belated

competitive offerings have given rise to a consensus among securities analysts and the press that AT&T's strategy is the one that the dominant providers fear most – and hence that proponents of the public interest should encourage.

52. The stampede of anticipatory competitive offerings in the wake of the merger *proposal* refutes any possible claim that the competitive benefits of the proposed merger will be nonexistent or trivial. The competitive benefits of the merger are no longer a matter of speculation. They have already begun to occur.

D. Joint Ventures And Other Contractual Arrangements Are Unlikely To Achieve The Same Public Interest Benefits As The Merger.

53. Certain opponents of the merger assert that its competitive benefits could be attained as readily through joint ventures or similar contractual arrangements.³ It is true that contractual arrangements short of full integration can, in certain circumstances, yield significant synergies. But opponents of the merger do not even attempt to show that such circumstances are present here, and for good reason. Great uncertainty about technology and service advances and the impact of such advances on consumer demand and competitors' offerings is a powerful deterrent to any long-term contractual arrangement that requires contract-specific investments and commitments by one of the contracting parties to share its facilities capable of providing multiple services. And it is difficult to imagine an industry characterized by greater uncertainty in this regard. In these

³ See SBC at 49-50; Bell Atlantic at 56; GTE at 69-72; Consumers Union at 25-26.

circumstances, the testimony of the leader of AT&T's cable telephony joint venture efforts and the head of MediaOne's strategy group that joint venture arrangements, to the extent they can be consummated at all, are unlikely to provide the full consumer benefits of integration are consistent with the predictions of economic theory and should be credited. *See* Wingfield Decl; Holmes Decl.

54. The attractiveness of a joint venture or other contract as a substitute for vertical integration by merger depends largely on two factors: (1) the amount of contract-specific investment that each party must make in the contract, and (2) the ability of the parties to negotiate a "complete" contract – *i.e.*, one that anticipates and specifies the parties' rights and duties under all circumstances.

55. By contract-specific investment, we refer to expenditures (1) which a company must make to perform its obligations under a contract, or to receive the benefits of the other party's performance, but (2) which cannot be recovered should the company terminate the contract before full performance by the other side. Examples of such investment include the expenses of promoting or marketing a trade name controlled by the other party, training personnel in the use of a product or process that is proprietary to the other party, or acquiring equipment or supplies that are useable only with the other party's goods or services.

56. Where contract-specific investments are insignificant, businesses typically do not need to merge with their suppliers or customers. Most businesses obtain their stationery and office supplies from third-party vendors rather than from a wholly-owned subsidiary. As computer monitors have become fungible commodities, companies like Dell and Compaq typically buy them from third-

party vendors rather than build their own. If the contractual arrangement becomes unsatisfactory, the buyer can readily switch to an alternative supplier with little or no loss of sunk investment in the original contract.

57. A contract that requires a party to make significant contract-specific investments, however, renders that party vulnerable to appropriation of some or all of its investment by the other party if the costs or benefits of performing the contract unexpectedly change after the contract is signed. At the extreme, the party satisfied with the existing contract could hold up the other party for an additional payment as large as the latter party's contract-specific investment before the latter party would find it economically advantageous to walk away from the contract. *See generally* Oliver Hart, *Firms, Contracts and Financial Structure* 29-55 (1995); Jean Tirole, *The Theory of Industrial Organization* 21-23 (1990).

58. Assume, for example, that Fisher Body had remained an independent company rather than becoming a wholly-owned subsidiary of GM. In the event of an unexpected rise or fall in the demand for GM cars, GM's ability to negotiate a contract amendment changing the quantity of bodies supplied by Fisher Body would be impaired by GM's investment in assembly line equipment compatible only with Fisher Body products. Likewise, in the event of an unexpected rise in Fisher Body's labor costs, Fisher Body's ability to negotiate a contract amendment increasing the price of the bodies would be impaired by Fisher Body's investment in tools and dies compatible only with GM designs. *See* Benjamin Klein *et al.*, "Vertical Integration, Appropriable Rents, and the Competitive

Contracting Process,” 21 *J.L. & Econ.* 297, 308-10 (1978) (explaining General Motors's decision to manufacture its own auto bodies).

59. To a certain extent, the risk of appropriation of contract-specific investment can be minimized by drafting contracts that specify in advance an appropriate set of changes in price or other contract terms for each potential change in economic circumstances. Cost-plus arrangements, price escalation clauses, sliding scale discounts for quantity purchases, and liquidated damage clauses are examples of these provisions. The effectiveness of these contingency clauses, however, is limited by the powers of human foresight. The more unpredictable and uncertain the economic environment, the more incomplete the contractual safeguards are likely to be. When a vertical supply relationship requires substantial contract-specific investment in an uncertain economic environment, vertical integration by merger is likely to be the preferred alternative to contracting. Economists have shown that requiring market participants in these circumstances to obtain critical inputs through contracts rather than merger is likely to result in underinvestment and insufficient new entry.⁴

60. The rollout of telephony and Internet services over cable networks involves both large contract-specific investments and enormous uncertainty. The contract-specific investments include the costs of research and development, licenses and permitting, acquisition of real estate and capital assets, installation of cable and customer premises equipment, marketing and advertising, and

⁴ See generally, Ronald H. Coase, “The Nature of the Firm,” reprinted in *The Firm, the Market, and The Law* 46 (1998); O. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* 82-105 (1975); J. Tirole, *supra*, at 25; Alan J. Meese, “Price Theory and Vertical Restraints: A Misunderstood Relation,” 45 *U.C.L.A. L. Rev.* 143, 168 (1997) (footnotes omitted).

staffing of customer care centers. Many of these investments, once made, are contract-specific (in the sense that they could not be redeployed elsewhere by a party that withdrew from the project) and sunk (in the sense that they could not be recovered even upon termination of the project).

61. The development of cable broadband telephony also entails enormous technological and commercial risks. Because cable broad-band telephony is in its infancy, the costs of marketing the service, the speed and extent of market penetration, the price levels and structure permitted by competition, the break-even volume, and the ultimate profitability of the service are all large unknowns.

62. Even more fundamentally, technologies and services are rapidly evolving and converging; hence, no one can reliably predict what business models, service offerings or technologies are likely to emerge as successful even over the next few years. As Mr. Wingfield and Mr. Holmes explain, this uncertainty makes it extremely difficult for a cable company that owns facilities potentially capable of providing multiple existing and future services, and a telephone company that wants to use those facilities to compete with the offerings of incumbent LECs whose facilities likewise have multiple potential uses, to agree in advance on limits on the services that the telephone company will offer and the amount of cable bandwidth it may use. The cable company will, of course, insist on some limits; an arrangement free of limits that encouraged a venture only partly owned by the cable company to compete directly with the cable company's 100%-owned core business would surely incur the wrath of shareholders. *See Holmes Decl.; Wingfield Decl.* And, it is far too early to reliably

predict which services – telephone, video, interactive online or other – will achieve the greatest commercial success, and thus how much of the cable bandwidth should be allocated to each service.

63. At the same time, AT&T is properly concerned that contractual limitations that might be imposed on the basis of imperfect information today could have the unintended effect of hampering the ability and flexibility of the joint venture to respond to offerings of the incumbent LECs that may flow from technology or other advances. *See* Wingfield Decl. How, for example, could a joint venture limited to plain old telephone service hope to compete with a successful incumbent LEC videophone offering?

64. Our conclusions about the likely difficulties with joint venture contractual arrangements are, unsurprisingly, confirmed by AT&T's own experiences in trying to negotiate such contracts. As explained in detail in the accompanying Declaration of Mr. Wingfield, although AT&T has been negotiating with a number of unaffiliated cable companies for more than a year, it has yet to reach agreement for a telephony joint venture with any such company. *See id.*

65. We do not mean to say, of course, that joint ventures are impossible or that they will not bring public interest benefits. We mean only to say that they are a less effective solution in this area. Because the parties to such a contract must necessarily divide the risks and gains *ex ante* on the basis of very imperfect information, absent extreme good fortune or prescience on the part of the contracting parties, the constraints the contract places on the venture's flexibility in responding to competitive offerings is likely to deny consumers many of the benefits that a full merger would bring.

IV. THE HEAVY-HANDED INTERNET REGULATION PROPOSED BY OPPONENTS OF THE MERGER WOULD NEEDLESSLY HARM THE PUBLIC INTEREST.

66. The most vigorous assaults on the merger come not from those who would enjoin it outright, but from those who would impose broad new public-utility type regulatory restrictions on the merged entity's fledgling provision of cable-based Internet and online services. The proponents of this regulation – the incumbent LECs, AOL, and others who today dominate the Internet and online services business – claim that it is necessary to prevent AT&T, a relative newcomer, from leapfrogging to the front of the pack. To remedy this supposed future problem, they urge prophylactic regulation now. These heavy-handed regulatory schemes are completely unwarranted and counterproductive to the public interest

67. Prophylactic regulation for problems that do not exist, in markets that have not fully developed, is always a dangerous enterprise. At a minimum, those who favor such regulation should bear the burden of proving two things: (1) the risk of monopoly power is great enough to warrant regulation; and (2) the proposed regulatory standards will actually make consumers better off. As explained in the following pages, neither of these conditions holds here.

68. The concerns that are said to motivate the proposals of forced access, whether plausible or not, also have nothing to do with the merger. However one handicaps the future scenario posited by the proponents of prophylactic regulation – a future in which cable-delivered services emerge from relative obscurity to market dominance, sweeping away dial-up access to the Internet over the lines of the incumbent LECs, content and ISP giants like AOL, as well as all present and future alternatives – that scenario has nothing to do with this merger. If the proponents of forced access are right in

predicting that future consumers will so prefer cable-delivered online services that alternatives will wither on the vine, then AT&T and MediaOne, each acting alone, would enjoy the same “power” over the customers in their respective service areas as the proponents of forced access posit for the combined entity. And the same would be true for all other cable companies. For that reason, even apart from their substantive defects, forced access concerns are clearly misplaced here. As the Commission concluded earlier this year in rejecting identical forced access proposals – those concerns “would remain equally meritorious (or non-meritorious) if the merger were not to occur.” *AT&T-TCI* ¶ 96.

A. Centralized Regulation Of Access And Access Pricing Is Unwarranted And Counterproductive In The Absence Of Monopoly Power.

69. There is a universally accepted economic and public policy framework for determining when regulators should regulate the terms and conditions under which one firm provides access to its facilities or services. This framework includes several bedrock principles:

- (a) Public utility regulation should be confined to relevant markets in which there is a natural monopoly.
- (b) Access regulation should be confined to where there is a bottleneck that is an essential monopoly in a relevant market.
- (c) Tying and bundling regulation should be confined to situations in which there is monopoly power over the tying product *and* a real danger of creating market power in a relevant tied market.

70. In the absence of such market failures, there is simply no justification for undertaking such a daunting task as substituting a centralized decision for the competitive market process in arriving at the optimal prices, quantities, technology and business model. Regulation of access is at best a necessary evil, which can never do more than approximate the performance of a competitive market. In practice, the results of such regulation are almost always markedly inferior to the outcome of unregulated competition.

71. There are several reasons for this empirical fact. First, “open access” is an intensely regulatory process. As described in detail below, to enforce open access, the regulator must set terms and conditions of access and establish a mechanism for enforcing them and for resolving disputes over the parties’ obligations. For services as complex and multidimensional as online services, this is a huge undertaking. The regulator must also set the price of access, an issue about which many of the parties seeking “open access” here are notably silent.

72. Resolving these issues inevitably entails protracted regulatory disputes before the Commission, the courts and Congress.⁵ The three years of still-ongoing litigation over the terms and

⁵ Commissioner Powell has aptly summarized “the expense . . . [m]andating open access to cable could unleash.” See Remarks by Michael K. Powell, Before the FCBA (Chicago Chapter), Chicago, IL (June 15, 1999) <www.fcc.gov/speeches/Powell/spmcp902.html> (“[I]t seems inescapable that if we mandate a right to equal access to cable plant, we will quickly find ourselves mired in ‘common carrier-like’ regulation. Undoubtedly, the minute that an entrant asks to have access to a proprietary cable Internet system, there would be disputes over the price. . . . Calls for collocation rules would soon follow [as would] [d]isputes over ordering (OSS), disputes over maintenance and trouble ticketing.”).

conditions of interconnection and access to unbundled network elements of the local Bell networks – where, unlike here, the criterion of bottleneck control of an essential facility is met – should refute any notion that “open access” to cable networks will be a quick or simple process.

73. The costs of the regulatory process go beyond the fees of the armies of lawyers, economists, accountants, lobbyists and other experts needed to compete effectively in the regulatory arena. More significant, if harder to quantify, are the opportunity costs of the managerial time and attention diverted from running the business. Deregulation of the airline, trucking and railroad industries (among others) in recent decades teaches that potentially competitive industries, when unshackled from regulatory oversight, become much less bureaucratic and more entrepreneurial and innovative in their managerial mindset. Reregulation (or new regulation) has the opposite effect.

74. Perhaps the greatest deficiency of centralized access regulation is the imperfect information available to the regulator. No centralized regulator – no matter how intelligent, conscientious and well informed – can approach the responsiveness and suppleness of the feedback loop known as the free market. Nor can any regulator approach the market’s effectiveness in matching the wants and needs of consumers with the technology and resources available to producers, now and in the future.

75. And centralized regulation of access and its pricing is likely to be especially disastrous here. The relevant technologies – digital communications, the Internet, computers – are among the most complex, revolutionary and rapidly evolving in history. These fields are also undergoing rapid

market convergence with telephony, data transmission, interactive online services, and video increasingly available over all the major transmission media. See Notice of Inquiry, *Inquiry Concerning the Deployment of Advanced Communications Capability to All Americans in a Reasonable and Timely Fashion*, 13 FCC Rcd. 15280, ¶ 2 (1998) (“Section 706 Notice of Inquiry”). No one can predict where all of this change will ultimately lead, but all of the trends – declining prices, increasing quality and rapid innovation – are positive, have created one of the most impressive economic booms in recorded history, and, most agree, are largely attributable to a consistent regulatory philosophy best characterized by the simple phrase “hands off.”

76. In this dynamic environment, any centralized scheme of forced access and price regulation is likely to be dysfunctional from the outset, and increasingly dysfunctional as time passes. The overwhelming harm of unnecessary forced access is total paralysis of one of the most dynamic markets the world has ever seen.

77. We have advocated – and continue to advocate – regulation of access and its pricing as a necessary evil for essential services or facilities over which the owners retain monopoly power. Interconnection to the local telephone network and unbundled network elements are examples of services and facilities where access regulation unfortunately remains necessary – both to foster competition in existing monopoly markets and to prevent incumbent providers from extending their monopolies over traditional services to new services before competition has a chance to develop. In the absence of comparable problems, however, centralized access regulation is likely to produce only a deadweight loss to consumers. Here, we agree with Commissioner Powell that regulators should:

start with a rule of decision . . . that anyone advocating the extension or intrusion of regulation into such a vibrant market bears a heavy burden of providing that the public will be harmed, absent doing so. . . . We should favor antitrust application to actual, substantial harms to consumers over industrial policy. Government-orchestrated industrial development may be unwise generally, but it is especially inappropriate in a market like the Internet. . . . [W]e should carefully assess the cost of regulation, including direct costs, indirect costs, and opportunity costs.

Remarks by Michael K. Powell, Before the FCBA (Chicago Chapter), Chicago, IL (June 15, 1999)

<www.fcc.gov/speeches/Powell/spmcp902.html>.

78. This rule of decision disposes of the amorphous appeals to “regulatory parity” offered by several independent LECs as a justification for regulation. According to these parties, their existing obligation to provide unbundled access to their local telephone networks warrants that the Commission likewise require AT&T to “unbundle” *its* last-mile data transport facilities. SBC at 43-47; US WEST at 17-20; Bell Atlantic at 40-43.

79. This crude appeal to playground justice is completely ungrounded in sound economic theory. Most significantly, the regulatory parity argument ignores the clear differential in competition and risk that incumbent LECs face in deploying broadband services and that cable companies face. First, cable companies start with no telephone or Internet customers. In stark contrast, incumbent LECs have nearly all the customers today (both telephone and those that buy dial-up Internet access) and continue to have monopoly power over basic phone services. Moreover, the basic infrastructure used by incumbent LECs to provide high speed services was deployed by incumbent LECs under a regulatory regime that shielded them from competition and guaranteed a return on equity. And the incumbent LECs faced no research and development risk with regard to the use of DSL technology;

Bell Labs developed it in the 1980s. *See, e.g.,* “Telecommunications (A Special Report): Cable Connection,” *Asian Wall Street Journal*, 1996 WL-WSJA 12474757 (Sept. 23, 1996). By contrast, cable companies must bear the full risks of developing and deploying cable modem services in a vigorously competitive market. And although the incumbent LECs can upgrade their plant one line at a time as they gain customers, cable company infrastructure demands massive area-wide upgrade investments before a single customer in the area can be served.

80. Differential regulation is also necessary to prevent incumbent LECs from abusing their bottleneck monopolies. If incumbent LEC DSL offerings were unregulated, incumbent LECs could simply stop offering POTS and require customers that wanted basic phone service to buy DSL service. This would allow incumbent LECs to migrate captive local telephony customers to DSL before cable telephony or any other alternative to these monopoly services is available.⁶ Then the LECs could exploit their telephony monopoly over local customers without regulation, by means of pricing of local services to end-users as well as pricing of access to long distance providers, all under the rubric of DSL offerings.

⁶ In this regard, Rubinfeld/Sidak’s claims that our prior testimony is contradictory with AT&T’s position is flatly wrong. Declaration of Daniel L. Rubinfeld and J. Gregory Sidak, filed on behalf of GTE Service Corp. *et al.*, ¶ 69 (Aug. 23, 1999) (“Rubinfeld/Sidak Decl.”). According to Rubinfeld/Sidak, AT&T’s position on forced access to cable systems cannot be reconciled with our testimony that incumbent LECs should be required to provide unbundled access to DSL. *Id.* As set forth above, there are clear differences between incumbent LECs and cable companies that create the need for differential regulation. Moreover, we do not advocate never-ending regulation of incumbent LECs’ advanced services. Once there is demonstrated and widespread competition in their local markets, those offerings should be deregulated.

B. The Merger Will Not Confer Monopoly Power on AT&T in Any Relevant Market.

81. In contrast with the incumbent LECs, the cable networks that AT&T seeks to acquire and upgrade are not essential facilities. Opponents of the merger have not shown – and cannot show – that AT&T has monopoly power in any relevant market. As detailed below, the Internet and online services market is extremely broad and populated by multitudes of well-financed and highly aggressive competitors. No firm, with the possible exception of AOL, dominates today. Nor, as explained below, is there any reason to believe that the merger will confer monopoly power on AT&T, a firm which is, at best, in the middle of the pack in terms of customers and experience for Internet services. Rather, driven by vigorous competition in its post-merger markets, AT&T will have every incentive to offer the most attractive package of services and price that can be devised and practically delivered. Because consumers will have competitive alternatives to every AT&T service, AT&T jeopardizes its huge investment in MediaOne unless it finds the right answers for consumers. In this regard, AT&T's incentives are aligned with the public interest. If AT&T fails to put together the best service offerings, it will lose the race to rivals who do a better job. The moment AT&T bores or antagonizes consumers, they will simply go elsewhere – to one of the hundreds of other firms providing competing services. Moreover, it is important to recognize that AT&T's burden is not just to *retain* customers – most existing customers are served by AOL and other Internet giants over the facilities of incumbent LECs – but to convince the customers of *other* providers to go to the trouble of *switching* their service.

1. AT&T's Services Must Compete With Narrowband Services.

82. Parties seeking regulation of AT&T attempt to avoid these inevitable conclusions by positing narrow “markets” that have no basis in economics. More specifically, they assert that there is

a distinct market for broadband last-mile data transport. GTE at 16-18; US WEST at 14-15; Bell Atlantic at 39-43; SBC at 40-43. But as we explained in our Affidavit in the *AT&T-TCI* merger proceeding, broadband and narrowband last-mile data transport are plainly competing products. See Declaration of Professors Janusz A. Ordover and Robert D. Willig, CS Docket No. 98-178 (filed FCC Nov. 13, 1998) ("Ordover-Willig TCI Decl."). There is now, and will continue to be for the foreseeable future, a great deal of demand cross-elasticity and opportunities for substitution between the two modes of Internet access.

83. To be sure, there are several advantages that broadband data transport over cable has in comparison with the traditional narrowband service. The first advantage is speed and bandwidth of transmission. The second advantage is that the connection to the Internet is "always on." But there are also disadvantages, and the facts suggest that many consumers find the combination of purchasing a LEC phone line in conjunction with dial-up internet access service more attractive than the integrated service provided by AT&T (or any other cable company that has upgraded its cable distribution system). Traditional dial up modem service uses customers' existing premises equipment ("CPE"). Moreover, purchasers of AT&T@Home service cannot use that service to access the internet or use e-mail from remote locations. Finally, when customers choose to purchase a second phone line to use with a dial-up modem service, those customers can effectively achieve "always on" access and, in addition, can use that second line for regular voice communication, as well as for a fax. By contrast, consumers who purchase a cable company's online service may not be able to use that capability to make phone calls, hook up a fax machine, or dial up to an employer's server.

84. Actual marketplace evidence confirms that narrowband service is an attractive substitute for broadband services for many consumers, and explains why AT&T's business leaders, in fact, price the AT&T@Home service to compete with dial-up service. See Marshall Decl. "Broadband" internet customers do not simply appear, they must be convinced to switch from their current narrowband providers. And AOL, for one, believes that is likely to continue to be a hard sell. Indeed, AOL's chief executive officer has predicted that in "five years, "seventy-five percent of the market will be narrowband because people want it to be as easy and inexpensive as possible."⁷

85. These factors unambiguously confirm that there is and will continue to be a great deal of demand cross-elasticity and opportunities for substitution between broadband and narrowband services, and thus that there is no separate broadband market.

86. Although the economists that make the claim that a separate broadband market exists do not address, let alone dispute, this evidence, they advance a welter of arguments that purport to demonstrate that narrowband transport does not compete with broadband transport. None of these arguments is sound.

87. Professor Gertner contends that broadband is a separate market because, supposedly, the "[p]rices charged by cable companies for @Home and Road Runner vary from area to area although prices charged by narrowband providers are generally uniform nationwide." Declaration of

⁷ *Power Lunch*, Television Interview with Steve Case (CNBC Broadcast, September 28, 1998).

Robert H. Gertner, filed on behalf of GTE Service Corp. *et al.*, ¶ 12 (Aug. 23, 1999) (“Gertner Decl.”). But the price variations for cable broadband are not large. According to the Web page cited by Gertner, there is only a \$5-per-month difference in the cost of @Home service between the high-priced areas and low-priced areas. In any event, Gertner is mistaken in stating that the cost of narrowband Internet access is uniform nationwide; his analysis ignores the significant variations in the cost of a second telephone line.

88. Gertner also asserts that “if narrowband and broadband Internet access were close substitutes, then AT&T would be expected to undertake the less costly investment of providing narrowband services” rather than making a huge investment in broadband. Gertner Decl. ¶ 12. But a company’s willingness to invest large sums to develop an *improved* product says nothing about whether the improved product is in a separate antitrust market.

89. Both Gertner (¶ 12) and Messrs. Rubinfeld and Sidak (¶ 25) point to price differences between broadband and narrowband as evidence that they are in separate markets. But it is normal to see a wide range of prices for offerings within a single product market. Indeed, not long ago it was common for Internet service providers to charge higher prices for a 56 kbps connection than for a 28.8 or 14.4 kbps connection, yet, in arguing that there is a single “narrowband” product market, Gertner and Rubinfeld/Sidak acknowledge that all these forms of transport are in the same market.

90. Actually, what is striking is how *small* a difference there is between the cost of narrowband Internet access and the cost of broadband Internet access. In fact, when the Commission

examined retail prices earlier this year, it found that the monthly cost of broadband Internet access via cable modem is *exactly the same* as the monthly cost of narrowband Internet access, and the “total first-year costs” were actually lower with the cable modem.⁸ The only reason that Gertner and Rubinfeld/Sidak found a significant price difference is that, unlike the Commission, they ignored the cost of an additional dedicated telephone line – a cost that is commonly incurred by heavy Internet users, who are the people most likely to be attracted to broadband access.

91. In addition, Rubinfeld/Sidak claim that broadband and narrowband Internet are distinct markets because users have different “demographic profiles.” “Narrowband Internet users interested in broadband are more likely to be male, younger, less wealthy, and spend more time on-line than those who are not.” Rubinfeld/Sidak Decl. ¶ 22. But demographics do not define antitrust markets, especially where there is no price discrimination based on the demographics. – The demographic differences are not pronounced – for instance, the average annual household income for one group was \$62,000; for the other group it was \$54,000. And any such differences would be bound to change if broadband service were to expand, since such expansion is most likely to come through substitution from narrowband service. Of course, such substitution is the hallmark of a relevant market that includes both narrowband and broadband service options.

⁸ Report, *Inquiry Concerning the Deployment of Advanced Communications Capability to All Americans in a Reasonable and Timely Fashion*, 14 FCC Rcd. 2398, ¶ 87 & Chart 3 (1999) (“706 NOI Report”).